DECISION MEMORANDUM

TO: COMMISSIONER KEMPTON
COMMISSIONER SMITH
COMMISSIONER REDFORD
COMMISSION SECRETARY
COMMISSION STAFF
LEGAL

FROM: DON HOWELL
DEPUTY ATTORNEY GENERAL

DATE: DECEMBER 11, 2009

SUBJECT: MIDVALE'S PETITION AND APPLICATION FOR A DECLARATORY ORDER REGARDING ITS ESOP, CASE NO. MID-T-09-03

On September 22, 2009, Midvale Telephone Exchange (Midvale) filed a Petition for Declaratory Ruling requesting Commission approval of: (1) the transfer of all assets and liabilities of Midvale to a successor company, Midvale Telephone Company (MTC); (2) the proposed contributions by MTC to an employee stock ownership plan (ESOP); and (3) the acquisition by the ESOP of the authorized and unissued shares of Midvale stock. Midvale also requests that its Certificate of Public Convenience and Necessity (CPCN) No. 254 be transferred to MTC.

BACKGROUND

Midvale (a Title 61 regulated company) is currently owned by two shareholders, Lane Williams (50%) and the Estate of Shirley Archer (50%). Midvale maintains that, since Shirley Archer's death, it has been exploring options to ensure its continued existence and ongoing operations with the least impact on its customers, services and employees. Mr. Williams and Midvale's Board of Directors believe that the best method to achieve their stated goals is to transfer the ownership of the corporation to its employees through an ESOP. Midvale adopted an ESOP on December 22, 2008. On August 27, 2009, Midvale incorporated Midvale Telephone Company (MTC).

THE APPLICATION

Midvale proposes to transfer to MTC all of Midvale's assets and liabilities (including all operating assets, all debt, all public licenses and the CPCN) in exchange for all of the issued and outstanding shares of MTC stock. After the proposed transfer is complete, the ESOP would acquire a portion of the Midvale stock held by Mr. Williams and the estate of Ms. Archer. Midvale would then redeem the remainder of the shares from the current ownership by delivering to Mr. Williams and the Archer estate a promissory note for the full value of their remaining Midvale shares. Upon a favorable Commission ruling and completion of the transfer, MTC would adopt the ESOP and contribute funds to the ESOP annually as retirement fund contributions for its employees. The Company asserts that the tax advantages of the proposed transactions are substantial.

On November 10, 2009, the Commission issued Order No. 30943 requesting public comments on Midvale's Application and Petition. Comments were due no later than December 8, 2009. The only comments filed were submitted by the Commission Staff. Midvale indicated that it would not be filing reply comments.

STAFF COMMENTS

The goal of Midvale's ownership and Board of Directors is to ensure the Company's ongoing operations with the least impact on its customers, services and employees. In this regard, several options were considered, including the sale of stock to Midvale's employees or to a third party, the redemption of stock by Midvale, the transfer of stock to Midvale's employees though the use of an ESOP, or a sale of the assets and liabilities of Midvale to a qualified third party and the discontinuance of service by Midvale. Mr. Williams and the Board of Directors determined that the transfer of Midvale ownership to its employees through an ESOP is the best method to achieve its goals with little or no disruption to its customers and employees.

After reviewing the Company's Petition and Application along with other information provided by the Company, Staff is generally supportive of the Petition for Declaratory Ruling. However, Staff has concerns regarding the ratemaking treatment of the ESOP contributions and other expenses associated with the transfer of ownership. Comments at 2-3.

A. Assets and the CPCN

The proposed transaction contemplates the transfer of all of Midvale's assets and liabilities to MTC in a tax-free "Section 351" capitalization in exchange for all of the issued and outstanding shares of MTC stock. As a result of this transaction, Midvale's existing employees and customers will become the respective employees and customers of MTC. Upon completion of the transactions, Midvale will have no assets other than a 100% ownership interest in MTC and will have no liabilities other than obligations for payments due under the Redemption Notes. *Id.* at 3. Because MTC would own and operate all of the operating assets to provide telecommunication services to Midvale's customers, MTC would need to become the holder of the Certificate of Public Convenience and Necessity and would be "subject to Commission regulation." *Id.* at 4. MTC would also hold all of the debt currently held by Midvale with the Rural Utilities Service and the Rural Telephone Finance Cooperative, but it would have no additional debt obligations as a result of this transaction.

The Company asserts and Staff believes that the current customers of Midvale will not be adversely affected by the proposed transactions. Therefore, Staff recommends that the Commission approve the transfer of all assets and liabilities, along with the CPCN No. 254, from Midvale to MTC.

B. The ESOP

If the Commission issues a favorable declaratory order on the Application, MTC states it will adopt the ESOP plan and trust already adopted by Midvale. MTC would then contribute funds to the ESOP on an annual basis as a retirement fund contribution for its employees. Midvale asserts that there is no specific provision under Idaho Code, Commission rules or other regulations governing telecommunications carriers which require the Commission to approve: (1) the structure of payment under the ESOP; (2) the amount of the contribution; or (3) characterize the contribution as a utility expense. Comments at 3. Therefore, Midvale states its petition for declaratory ruling in this matter is more or less a request that the Commission inform Midvale if the Commission believes it must approve any of the above items or any other items with respect to the creation of the ESOP pursuant to any of the Commission's regulatory powers.

Idaho Code § 61-901 requires that the Commission approve "instruments of security" pertaining to utility assets. Midvale asserts that the operations of the Company will be unchanged and the adoption of the ESOP plan and trust will not impair the Company's assets. No additional debt or equity securities will be issued so Staff asserts that Commission approval under *Idaho Code* § 61-901 is not required. Staff also believes that Midvale is not required to obtain Commission approval to establish and adopt an ESOP plan and trust. *Id.* at 4.

However, Commission approval is required to transfer the Certificate of Public Convenience and Necessity Certificate No. 254. The Commission is also vested with the authority to establish rates that are just and reasonable. In this latter regard, the Commission has the authority to exclude from retail rates any contributions to the ESOP that it believes to be excessive. Denying recovery of costs in rates would not negate the ESOP plan even though the costs are not paid by customers. *Id.*

MTC intends to contribute approximately $400,000 per year to the ESOP plan and trust. The Company also sponsors a 401(k) plan where employees can receive up to 4% of their compensation in employer-matching contributions. Given that the Company's eligible payroll for 2008 was $1,909,443, the 2008 ESOP contribution of $400,000 represents 21% of eligible compensation. *Id.*; Application at 4. While Staff is aware of the advisability for utility companies to provide retirement benefits to employees, the annual ESOP contribution coupled with the employer matching contributions to the ESOP plan and trust create a level of retirement funding that could be considered excessive beyond the reasonable amount necessary to maintain qualified employees to provide service to its customers. Midvale, however, is not asking to include any ESOP contributions in retail rates at this time. Application at 5.

Midvale has also incurred significant consulting and legal expenses related to the establishment of the ESOP. The expenses have been booked to the Company's operating accounts for financial statement purposes. These accounts are above-the-line accounts that could be included in revenue requirement calculations to determine retail rates. The Company has not requested any rate relief at this time. If these expenses are included during a test year, Staff would likely recommend that these expenses not be recovered in rates paid by customers. Comments at 4. Staff believes that most of these expenses are personal estate planning expenses of the ownership of Midvale and it would be inappropriate to pass these expenses on to customers. Staff agrees with the Company that the tax advantages of the proposed transactions are substantial. In particular, Midvale asserts that use of the ESOP avoids paying federal or state income taxes. Application at 5. The owners will benefit from many of these tax advantages.

COMMISSION DECISION

Does the Commission:

1. Approve the transfer of all Midvale assets and liabilities to MTC?
2. Allow the ESOP to acquire the authorized and unissued shares of Midvale stock?
3. Approve the transfer of Midvale's CPCN No. 254 to MTC?
4. Intend to regulate MTC as a Title 61 telephone corporation?

5. Allow MTC to contribute to the ESOP absent ratemaking determination?

6. Reserve judgment until a future rate case on the amount of the ESOP contributions and the expenses of establishing the ESOP to be recovered in rates?

Don Howell
Deputy Attorney General

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